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Tax Incentive Programs

Evaluate today, improve tomorrow

Overview

From 2012 to 2014, 10 states and the District of Columbia passed laws that will require regular evaluation of economic development tax incentives or will improve existing evaluation processes. These laws stand to provide lawmakers with hard evidence on the outcomes of their incentives, information they can use to shape policies that obtain the best possible results for the states' taxpayers and economies. To see which states have enacted evaluation laws since the start of 2012, visit pewtrusts.org. A number of additional states are considering similar actions.

This report advises states on how to design and implement these laws, so that tax incentives are evaluated regularly and rigorously and so that lawmakers can use the findings to improve economic development policy. Building on the best practices developed in the 11 jurisdictions and elsewhere, the recommendations focus on three steps states should take to improve the accountability and performance of their tax incentives:

1. **Make a plan:** Determine who will evaluate, when, and how.
2. **Measure the impact:** Assess the results for the state's economy and budget.
3. **Inform policy choices:** Build evaluation into policy and budget deliberations.

Make a plan: Determine who will evaluate tax incentives, when, and how

Ensure that incentives are regularly and rigorously reviewed

Determining how frequently tax incentives should be evaluated involves striking a balance: Programs need to be studied often enough to provide policymakers with up-to-date information, but analysts need adequate time to produce thorough, detailed studies.

Most states with tax incentive review processes have adopted schedules to study different groups of incentives each year, rather than attempting to cover all programs at once. This approach allows states to leverage their existing resources for ongoing and regular evaluations, providing a balanced workload for analysts. It also lets lawmakers focus on a select set of programs each legislative session. In most states—including Connecticut, Florida, Indiana, Maryland, Mississippi, and Rhode Island—all incentives are reviewed at least once every three to five years. Some states have adopted longer cycles; Alaska conducts evaluations every six years and Washington every 10 because, in addition to incentives for economic development, they review a broad array of other tax exemptions, deductions, and credits.[1]

Table 1

Incentive Evaluation Processes in Select States

Policymakers tailor the length of the review cycle to the scope of the evaluation process

State	Scope of evaluation process	Years in review cycle
Rhode Island	Economic development tax incentives	3
Florida	Economic development incentives, including tax and cash programs	3
Oregon	Tax credits, including economic development incentives and other programs	6
Washington	Tax preferences, including economic development incentives and other credits, exemptions, and deductions	10

Source: Pew research

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Establish a strategic schedule

Concurrently reviewing tax incentives with similar goals can help evaluators compare the results of various programs and identify which provide the greatest return on investment. This approach also enables policymakers to study whether incentives with similar goals are being coordinated effectively.

Oregon's process reviews similar tax credits in the same year, placing those designed to promote education in one evaluation group, for example, and those created to further economic development in another.[2] Likewise, under a 2014 law, Alaska will evaluate incentives in groups based on which agency administers the programs.[3]

Where incentives have statutory expirations, or "sunsets," states should coordinate their evaluation schedules with those dates. Sunsets for tax incentives give policymakers a chance to decide whether programs should be extended, altered, or allowed to end. Evaluations can help lawmakers with these decisions. Oregon—which in 2009 placed sunsets on virtually all of its tax credits—schedules evaluations to finish in the months before each incentive is set to expire.[4] Washington and Maryland have also tried to synchronize their evaluation schedules with sunsets.[5]

> Evaluating tax incentives takes cooperation among multiple state offices or agencies.

Assign responsibilities for evaluation

Evaluating tax incentives takes cooperation among multiple state offices or agencies. For example, under a 2013 Florida law, two legislative staff offices use their distinct skills to review programs together. The Office of Economic and Demographic Research—with its background in economic analysis—studies the effects of incentives on job creation, revenue, and a variety of other useful indicators. The Office of Program Policy Analysis and Government Accountability, which specializes in examining the details of government initiatives, provides recommendations on how state agencies can administer incentives more effectively.

Alaska divides responsibilities for its evaluation process through a collaboration between the legislative and executive branches. The Department of Revenue works with other state agencies to report basic information on each incentive, including a description of the program, its goals, and its cost. Nonpartisan analysts in the Legislative Finance Division use that information to assess whether programs achieved their goals and to make policy recommendations.

Several states have had success working with experts outside of government to evaluate tax incentives, by contracting with academic or private sector economists. This approach can help states supplement the knowledge and skills of their employees, leading to more rigorous evaluations. Under a 2014 law, Mississippi's incentives will be evaluated on a four-year cycle by the University Research Center, an office within the state's higher education system that regularly conducts economic analyses for state government.[6]

Identify clear, measurable goals for each incentive

States often create tax incentives without clear goals. It is difficult to assess success when policymakers are unsure what the incentives are intended to achieve.

To resolve this issue, a 2013 Vermont law set up a process to draft proposed goals for each of the state's existing tax credits, exemptions, and deductions.[7] To do so, legislative staff studied the statutory description of the incentives and available legislative records. The following year, lawmakers adopted goals for each program based on this research.[8] Similarly, Nebraska approved in 2014 a law clarifying the purposes of its key tax incentives.[9]

Because a state's economic goals and strategies change over time, an evaluation process can provide an opportunity to revisit and refine the aims of incentives according to the latest state priorities. Rhode Island's law requiring regular evaluation of major economic development tax incentives includes a provision encouraging the evaluators to point out cases in which clearer goals would have made it easier to assess success.[10] The idea is to prompt lawmakers to revise the goals, allowing future evaluations to draw more definitive conclusions. Indiana included a similar provision in its 2014 evaluation law.[11]

Access reliable and relevant data

States are more likely to be able to rigorously measure the results of tax incentives when agencies share data effectively. For example, the Iowa Department of Revenue and agencies that award tax credits, such as the state's Economic Development Authority, have worked together to track when the state awards credits and when companies claim them on their tax returns.[12] Thanks to this effort, Iowa has better estimates of how much tax credits cost and has been able to perform more thorough analyses of its incentives.[13]

One challenge states face is providing detailed data to evaluators while ensuring that sensitive company-specific information remains private. For example, tax-collecting agencies are often statutorily forbidden from sharing tax return data, even with other state agencies. However, states have had success in creating exceptions to these restrictions while balancing confidentiality concerns. A case in point is Louisiana, where state law establishes a set of rules under which the economic development department may obtain and analyze company-specific data gathered by other agencies, including tax data from the state Department of Revenue.[14]

Often, states collect valuable information directly from the companies benefitting from incentives. For instance, data provided by film production companies in Massachusetts helped the Department of Revenue conduct a rigorous evaluation of the state's film tax credits. The study depended on knowing how much of the productions' spending went toward salaries for actors and directors—many of whom live out of state—as opposed to in-state residents and businesses. By distinguishing between these different types of employees, the data supplied by the production companies allowed evaluators to estimate how much economic activity the films generated for Massachusetts.[15]

Ensure that future incentives will be evaluated effectively

When states set up processes for regular evaluation, they typically require that incentives created in future years will also be studied. For example, Rhode Island evaluates existing tax incentives at least once every three years. Any new programs the state enacts are evaluated within five years of going into effect—to give them time to work before the state measures their results—and then subsequently every three years.[16]

States have also put in place policies designed to make sure that analysts will be able to successfully evaluate new incentives in the future. Several states, including Arizona, Colorado, New Mexico, and Vermont, require bills creating new tax incentives to define their goals in order to avoid any confusion about legislative intent when the programs are reviewed later.[17]

In 2013, Washington enacted a law requiring that proposed tax incentives include a "performance statement" designed to help the state's Joint Legislative Audit and Review Committee—which evaluates incentives on a 10-year schedule—determine whether the programs in question succeeded. Each statement documents the purpose of the tax incentive, how the state will know whether the program accomplished its goal, and what data evaluators will need to conduct the review.[18]

> States have analyzed the effects of tax incentives on employment, wages, economic growth, tax revenue, and dozens of other measures.

Measure the impact: Assess results for the state's economy and budget

Select metrics to determine how well incentives are working

There is no single best metric for assessing the results of economic development programs. States have analyzed the effects of tax incentives on employment, wages, economic growth, tax revenue, and dozens of other measures, and they should consider which of these metrics would best help determine whether a given program is achieving its objectives.

Because Minnesota's Job Opportunity Building Zones program was designed to help economically troubled communities, the legislative auditor prepared an evaluation of the program that assessed whether it had been effectively targeted to areas in need. The report's authors determined each community's level of distress based on measures such as unemployment and poverty rates. They concluded that more prosperous areas were just as likely to receive benefits as the struggling places the incentive was designed to help.[19]

> Although tax incentives provide benefits to businesses, they do so with the intent of helping people find jobs, increase their earnings, and become more economically secure.

Many evaluations study how incentives affect businesses, estimating the effects on companies' investment and expansion decisions. But although tax incentives provide benefits to businesses, they do so with the intent of helping people find jobs, increase their earnings, and become more economically secure. Therefore, evaluators should also select metrics that will show how incentives are affecting state residents. In Maryland, an evaluation of the state's Enterprise Zone program showed that many residents of the distressed areas whom the incentive was supposed to help were probably not benefitting from it. The study looked at the level of educational attainment of zone residents compared with that required by employers in the zones and found that many residents lacked the necessary skills. The report suggested coordinating the incentive more closely with state workforce training programs to help more of the target population benefit.[20]

Develop a reasonable timeframe for analysis

Some incentives provide benefits only after a company has met job creation or investment requirements. Others make incentives available upfront, even though the economic benefits will not materialize until later. To judge effectiveness, therefore, states need to study programs over a long enough period to adequately gauge their costs and benefits.

A 2014 evaluation of Massachusetts' film tax credit addressed this issue by measuring the program's cost per job since its creation in 2006. This approach helped smooth out changes in the tax credit's results from year to year that related to the timing of costs and benefits. For example, film production companies could only claim the benefits after they had created the jobs, so the program had an artificially low cost per job in the first year. On the other hand, it had an artificially high cost per job in 2010 because few movies were filmed in Massachusetts that year, but the state was still paying for credits earned in earlier years.[21]

Consider cause and effect

Tax incentives can provide economic benefits to states only to the extent that they change business behavior, such as by encouraging companies to create jobs or make investments they would not otherwise have made. Therefore, high-quality evaluations estimate the degree to which incentives spurred changes as opposed to rewarding what businesses would have done anyway.

One way states have done this is to study how large an incentive is in the context of a business' overall costs. For example, an incentive that reduces a company's costs by 10 percent is more likely to spur action than one that lowers them by 1 percent. An Oregon study of tax credits for renewable energy projects, such as wind and solar farms, determined the circumstances in which the incentives were substantial enough to change financially untenable projects into viable ones. The study found that smaller projects depended on the incentives more for their success, while some larger projects were likely to be built without them.[22] As a result, Oregon lawmakers modified the state's renewable energy incentives to focus on smaller-scale projects.[23]

Similarly, a 2014 Minnesota evaluation of a tax credit for angel investors—qualified individuals and investment funds that provide financing to small businesses—pointed out that some of the individuals receiving benefits had personal stakes in the companies in which they invested.[24] It concluded that these "inside investors"—often executives or board members—were less likely to need the incentives to encourage them to invest than were venture capitalists not affiliated with the companies. At the same time, the evaluation concluded that the incentive was a cost-effective option compared with alternative strategies for growing the state's economy. In response, the Legislature expanded the program but limited the ability of inside investors to participate.[25]

Estimate net effects

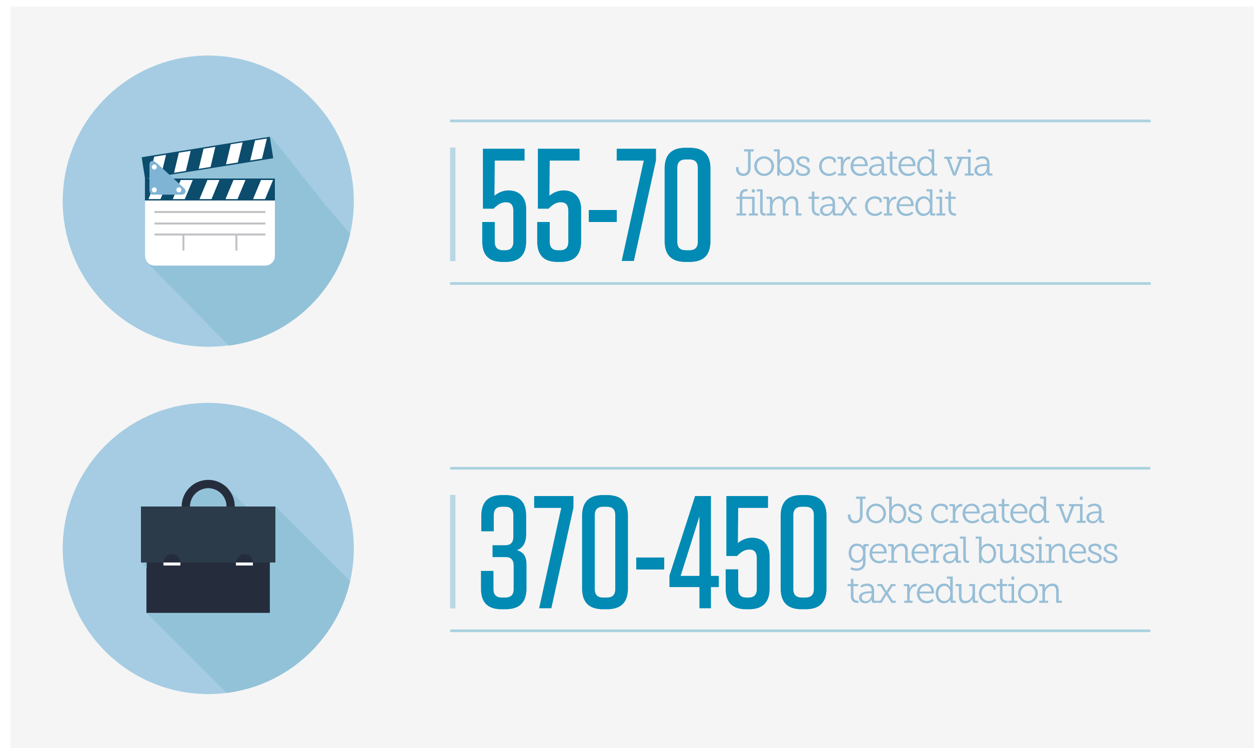
The impact of incentives is not confined to the companies that receive them and their employees. High-quality evaluations measure the net effect of incentives on the state economy by examining the positive or negative effects of incentives for other businesses and individuals.

An evaluation of Louisiana's Enterprise Zone used academic research on economic development to identify ways to reduce negative effects of the program on other state businesses. This research indicated that in certain economic sectors—retail, restaurants, hotels, and health care—many of the jobs for which companies received incentives were likely to have come at the expense of existing Louisiana jobs in those same sectors, negating much of the incentives' positive effects. The research also showed that these negative effects were far less likely

Table 2

Measuring the Effects of Tax Incentive Trade-Offs in North Carolina

Job creation from the state's film tax credit compared with an alternative policy



Source: North Carolina General Assembly Fiscal Research Division

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to occur in other sectors, such as manufacturing.[26] Subsequently, the Legislature limited eligibility for the program to direct more of the incentives to those sectors in which the net benefit for the state would be greatest.[27]

Compare the results with other economic development strategies

Like all state budget decisions, offering tax incentives involves a trade-off: A dollar used by a state on an incentive is a dollar that cannot go to other economic development programs, state services, or broad-based tax cuts. To accurately analyze the results of tax incentives, states must consider the economic effects of these trade-offs. One way to do so is to compare the effectiveness of tax incentives with that of alternative economic development strategies the state is pursuing or might pursue to achieve the same goal.

A study by legislative staff of North Carolina's film tax credit shows how significant this consideration is in measuring the results of incentives. According to the evaluation, the state's $30 million in film incentives created between 55 and 70 jobs in 2011. However, the report also found that an equally large cut in business tax rates would have had a bigger economic impact, yielding between 370 and 450 jobs.[28]

Inform decisions: Build program evaluations into policy and budget deliberations

Identify opportunities for improvement

High-quality evaluations go beyond simple yes-or-no verdicts on tax incentives and instead offer concrete recommendations for improving results. When an incentive is effective, means for obtaining better outcomes may still exist. When an incentive is not working well, the best approach might be to change it rather than eliminate it.

A review of Louisiana's Quality Jobs program pointed out several ways in which it risked encouraging the creation of low-quality jobs. For instance, the rules governing the tax credit did not ensure that employers who claimed it would provide employees with the level of health insurance policymakers had intended. In response, the state's economic development agency updated the rules to require companies to offer better coverage and to provide it for new employees within 90 days.[29]

Evaluations can also point out how incentives can work better for businesses. In Ohio, one of the state's key incentive programs required local governments to provide matching funds in order for companies to qualify. A 2009 evaluation found that the incentives were generally working well but that these local matches cost businesses more in transaction costs than they were worth while also placing a financial strain on local governments.[30] Based on the report's recommendation, lawmakers eliminated the local match requirement.[31]

Encourage lawmakers to regularly review incentives

One way states have ensured that policymakers consider the results of evaluations is to hold committee hearings in which key legislators can discuss the finding with the analysts who conducted the research. Several states, including Arizona, Iowa, Indiana, Maryland, Mississippi, and Washington, use this approach.[32] In addition, committees often use the hearings to receive input from taxpayers, businesses, and other stakeholders. Many of the panels also make policy recommendations, using what they have learned from the evaluations and testimony to provide guidance to the full Legislature.

A 2013 Rhode Island law connects the evaluations directly to the state's budget process. The governor's budget proposal must include recommendations on whether to continue, change, or end each incentive evaluated during the past year. Legislators then hold hearings on the recommendations, allowing lawmakers to consider tax incentives alongside other spending priorities.[33]

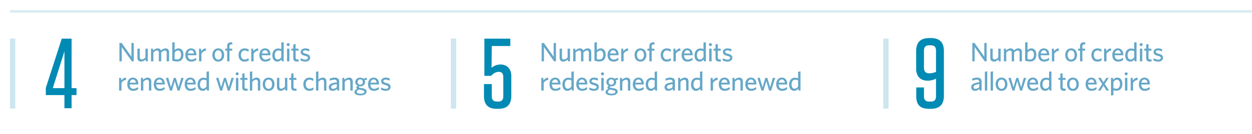
States have also placed statutory expiration dates, or sunsets, on tax incentives to encourage lawmakers to regularly review results. In Oregon, for example, most tax credits expire every six years unless lawmakers renew them.[34] This approach has led policymakers to identify and use information about the effectiveness of incentives as they debate whether the programs should be extended, altered, or allowed to expire. In 2011, the Oregon Legislature tasked the newly created Joint Committee on Tax Credits with reviewing and proposing changes to 18 expiring credits. The committee requested evaluations of the programs and held hearings to review the evidence and receive testimony from important stakeholders.

Ultimately, based on the committee's recommendation, the Legislature allowed some little-used credits to expire while it extended or redesigned others, including a tax credit for renewable energy projects, such as wind and solar farms, which had grown far more expensive than anticipated.[35] Lawmakers revised the program in 2011 to focus on smaller-scale projects,[36] after an evaluation found that the tax credit was less likely to influence whether larger-scale projects were built.[37] In addition to increasing the program's cost-effectiveness, the changes were expected to save Oregon $20 million over the next two years and hundreds of millions of dollars after that period.[38]

Table 3

Sunsets Spur Review of Incentives' Results

Oregon lawmakers' decisions on 18 tax credits scheduled to expire, 2011



Source: Joint Committee on Tax Credits, Oregon Legislature

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Conclusion

Policymakers want tax incentives to provide the best possible outcomes for states' economies and budgets. For that reason, measuring the results of these programs is critical. Doing so involves three steps: creating an evaluation plan, measuring incentives' impact, and connecting the results to the policymaking process. When states have taken these actions, they have been able to identify what is working and what is not. Then, lawmakers have succeeded in using that information to improve the effectiveness of their incentives. In this way, regular, rigorous, policy-relevant evaluations of tax incentives stand to make states more economically prosperous and fiscally sound, to the benefit of businesses, workers, and taxpayers.

Endnotes

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For further information, please visit:

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